DOCKET FILE COPY ORIGINAL

RECEIVED

SEP 10 1996

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, D. C. 20554**

| | | |
|---|---|---|
| In the Matter of | ) | |
| | ) | |
| Implementation of the Telecommunications Act of 1996 | ) | |
| | ) | |
| | ) | CC Docket No. 96-150 |
| Accounting Safeguards Under the Telecommunications Act of 1996 | ) | |
| | ) | |

# Reply Comments of BellSouth

BELLSOUTH TELECOMMUNICATIONS, INC.
BELLSOUTH CORPORATION
By their Attorneys

William B. Barfield
M. Robert Sutherland

Suite 1700
1155 Peachtree Street, N.E.
Atlanta, GA 30309-3610
(404) 249-4839

Date: September 10, 1996

No. of Copies rec'd 0+11
List A B C D E

## TABLE OF CONTENTS

# SUMMARY

This proceeding affords the Commission an opportunity to move in one of two directions: it can eliminate unnecessary regulation and allow competitive markets to work as Congress intended in the 1996 Act, or it can increase the regulatory burdens facing one group of competitors for the benefit of another, thereby denying consumers the fruits of the procompetitive, deregulatory national policy framework intended by Congress.

The interexchange carriers, other than Sprint, are of one mind: make the LEC cost allocation and affiliate transaction rules as onerous as possible, thereby ensuring that potential competition from the LECs is stillborn. AT&T, which in 1993 described the rule changes proposed in the Notice as "thoroughly impractical," "virtually impossible to implement" and imposing "staggering" costs, now finds the proposed rules "useful". MCI demonstrates its unquenchable thirst for new LEC regulations by proposing to drown the BOCs and their affiliates in a sea of new regulations and reporting requirements. LDDS WorldCom urges the Commission simply to ignore the compliance costs of new regulations, contrary to express mandates in the Act. Among the IXCs, only Sprint, which has LEC subsidiaries, approaches the proposed rules with a modicum of balance and objectivity.

In addition to their blatant opportunism, the IXC proposals have two other things in common: 1) there is no factual basis for their claims that new accounting restrictions are necessary; and 2) their proposals are in direct conflict with economic theory. The LECs have provided substantial, unrebutted economic evidence that cost allocation and affiliate transaction rules destroy productivity and impede economic efficiency. As such, they are contrary to the goals of the 1996 Act, and should be employed only when other, less onerous measures to protect consumers are not available.

BellSouth and the other LECs have shown that price cap regulation removes the incentives for cost-shifting and cross-subsidy that the current rules were designed to prevent. In a price cap environment, the existing cost allocation and affiliate transaction rules are superfluous and should be eliminated. In no event should more onerous rules be adopted.

One of the rule changes proposed in the Notice would make the asymmetrical asset transfer rules applicable to services transactions. This rule change would require LECs to perform both estimated fair market value and fully distributed cost studies for services transactions. This is the most onerous proposal in the Notice in that it would cause the LECs to incur massive new costs and would provide customers with essentially no additional protection. In its Comments, BellSouth submitted a study by Theodore Barry & Associates ("TB&A") that analyzed both the cost and the effectiveness of the proposed rule. TB&A also estimated the impact that the proposed rule would have on current and future affiliated relationships. For three BellSouth affiliates studied, TB&A estimated the cost of performing the required cost studies to be $14.4 million annually. USTA estimated that the cost of compliance for the LEC industry as a whole at approximately $91 million. These estimates did not include the costs associated with additional transactions with the separated affiliates required by the 1996 Act. These massive new costs have no value to the industry other than regulatory compliance. As such, each dollar of such costs is equal to a dollar of lost productivity. Nor would this change in the rules provide additional ratepayer protection. Even the parties advocating this rule change acknowledge that the fair market value for certain knowledge-based services cannot be estimated with precision, and any such analysis will be subjective. The TB&A analysis confirmed this flaw in the

Commission's proposal. TB&A concluded that the primary impact of adopting this proposal would be to discourage beneficial, efficiency-enhancing affiliate transactions.

The proposal to eliminate "prevailing company price" as a valuation method should not be adopted. The "prevailing company price" method most closely meets the statutory requirement of "arm's length" transactions. The alleged difficulty that the Commission staff has experienced in applying this methodology is essentially of its own making. By seeking to impose unreasonably high thresholds for finding a "prevailing company price", the staff has elevated form over substance. As AT&T argued in 1993, a market price is established if any significant group of market participants engage in arm's length transactions at that price.

The Commission should not attempt to extend its jurisdiction to intrastate matters. Sections 271-272 do not extend the scope of the Commission's jurisdiction to intrastate matters. In the absence of an express intent to override the jurisdictional limits imposed by Section 2(b) of the Act, any attempt by the Commission to exercise jurisdiction over intrastate matters is unlawful.

The Commission must reject attempts by IXCs and others to expand the scope of this proceeding beyond the issues raised in the Notice. The Notice defines the scope of the proceeding, and parties are entitled to rely on the Notice to define the issues that will be addressed in the Commission's decision. Attempts by the IXCs to inject new issues through their comments must be rejected.

**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, D. C. 20554**

| | | |
|---|---|---|
| In the Matter of | ) | |
| | ) | |
| Implementation of the Telecommunications Act of 1996 | ) | |
| | ) | |
| | ) | CC Docket No. 96-150 |
| Accounting Safeguards Under the Telecommunications Act of 1996 | ) | |
| | ) | |

**Reply Comments of BellSouth**

BellSouth Corporation and BellSouth Telecommunications, Inc. ("BellSouth") hereby reply to the Comments made in response to the Notice of Proposed Rulemaking ("Notice"), FCC 96-309, released July 18, 1996 in the captioned proceeding.

## I. Introduction

In its initial Comments, BellSouth demonstrated that cost allocation and affiliate transaction rules are economically inefficient and reduce the productivity of the carriers subject to them. When applied to price cap carriers, they are superfluous and ineffective. The changes in the affiliate transaction rules proposed in the Notice would greatly increase the cost and burden of compliance with no measurable improvement in customer protection.

Predictably, the most vocal proponents of increased regulation of the Bell Operating Companies ("BOCs") and their affiliates are the interexchange carriers ("IXCs") who will soon face direct competition from the BOCs for the first time. The IXCs would have this Commission convert the "deregulatory" intent of Congress in enacting the 1996 Act into "reregulatory" Commission rules. Their dyslexic reading of the 1996 Act, if adopted, would shackle the BOCs and their affiliates from the outset, thereby eliminating the major threat to their cozy oligopoly.

AT&T, the leader of the IXC cartel, now supports changes in the affiliate transaction rules that three years ago it described as "thoroughly impractical", "virtually impossible to implement" and imposing "staggering" costs.[1] AT&T does not even acknowledge its change in position, much less justify it. MCI, whose thirst for new burdens to impose on its competitors is unquenchable, proposes to drown the BOCs and their affiliates in a sea of new accounting and reporting requirements. LDDS WorldCom, the newest member of the IXC cartel, goes so far as to suggest that the Commission ignore the burdens that cost allocation and affiliate transaction rules impose on the BOCs and the other local exchange carriers ("LECs").[2] Freed of any pragmatic concerns, WorldCom proposes to smother the BOCs under a blanket of new regulations that would result in any potential BOC competition being stillborn. Among the IXCs

[1]Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions Between Carriers and Their Nonregulated Affiliates, Notice of Proposed Rulemaking, CC Docket No. 93-251, 8 FCC Rcd 8071 (1993)("Affiliate Transaction Notice"), AT&T Comments at 15. AT&T also advocated a cost benefit analysis prior to amending the rules, which is notably absent from its comments in this proceeding.

[2] LDDS WorldCom at 8, 20-21. The suggestion that the Commission ignore the burden that its requirements impose is patently absurd. Congress made it clear that the 1996 Act was designed "to provide for a pro-competitive, de-regulatory national policy framework . . .". See Joint Explanatory Statement of the Committee of Conference, CR-113. Section 10 of the 1996 Act expressly mandates that the Commission "forbear from applying any regulation or any provision of this Act to a telecommunications carrier" that is not required to promote the public interest. Section 11 of the 1996 Act requires the Commission to "repeal or modify any regulation it determines to be no longer necessary in the public interest." Section 1 of the Communications Act of 1934 charges the Commission with promoting "a rapid, efficient, nationwide and world-wide wire and radio communications service with adequate facilities at reasonable charges. . . ." Ignoring the cost of regulation does not meet the requirements of any of these sections of the Act. Burdensome regulations are not "efficient". Their application to only one segment of the industry is not "non-discriminatory". Requiring BOCs to incur unnecessary costs does not further "just and reasonable rates". Finally, wasteful regulation is not "necessary" to promote the "public interest." Contrary to WorldCom's view, the Commission clearly must consider both the cost and benefit of its regulations.

only Sprint, which has local exchange carrier subsidiaries, takes a more balanced and reasonable approach to cost allocation and affiliate transaction rules.[3]

None of the IXCs provide any evidentiary support for their request to increase the already heavy regulatory burdens that are borne only by the BOCs and other LECs. They simply parrot back the rationale offered in the Notice and ignore the evidence submitted in response to the Affiliate Transaction Notice that shows the premise underlying the argument for new rules is false. They ignore the fact that the proposed changes in the affiliate transaction rules will cause massive new costs to be incurred by the BOCs with no real increase in the protection afforded to consumers. As BellSouth demonstrated in its Comments, every dollar of increased administrative costs borne by a price cap LEC is a dollar of lost productivity, since these costs represent increased input that do not increase output.[4]

With its Comments, BellSouth introduced a study by Theodore Barry & Associates ("TB&A") that demonstrated that just one of the proposed changes in the affiliate transaction rules, the application of the asymmetrical asset transfer rules to services transactions, would cost BellSouth more than $14.4 million annually in increased compliance costs. The application of the proposed rule to the new affiliates required by the 1996 Act would increase those costs

---

[3] See e.g., Sprint at 13: "In sum, Sprint believes that the current valuation rules for affiliate transactions should be retained. As the Commission has found, such rules have worked well and are achieving their intended purpose. Under such circumstances, changing the rules for the sake of uniformity would not be in the public interest."

[4] As AT&T stated in 1993: "Just the existing rules require substantial effort and expense to ensure compliance. Worse still, the proposed rules would require AT&T to develop and maintain new administrative systems to track affiliate transactions. As Haring and Rohlfs discuss, such systems "have little value to the firm, apart from regulatory compliance. . . . Consequently, virtually the entire cost of [such a system] is a burden of regulation. Such compliance costs, and related costs such as those of an independent audit, are likely to be very substantial." Affiliate Transaction Notice, Comments of AT&T at 15. (citations omitted).

dramatically. Yet the change would result in little or no increased protection for ratepayers. Despite this unrebutted evidence, the IXCs (other than Sprint) continue to support this and other burdensome new rules that would apply only to the BOCs and other LECs.

In these Reply Comments, BellSouth shows that the requests for new regulations and reporting requirements to be applied only to the LECs and their affiliates would harm, rather than promote competition.[5] Such requests by potential competitors of the LECs represent self-serving, anticompetitive opportunism that, if adopted, would damage the public interest.

## II. The Premise that Cost Allocation and Affiliate Transaction Rules are Necessary to Protect Against Cost Shifting by the Price Cap LECs is False

Taking their cue from the Notice,[6] the IXCs argue, without supporting evidence,[7] that potential cost shifting justifies application of cost allocation and affiliate transaction rules to the price cap LECs and their affiliates. The premise is false. As AT&T stated in 1993:

> As a matter of fundamental economic theory, no firm (even one possessing market power) has an incentive to shift costs between separate productive activities because the profit-maximizing price and output are not affected by any

[5] See, e.g., Affiliate Transaction Notice AT&T's Comments at 15-16: "In addition, the continued imposition of these rules on AT&T would distort interexchange competition, because only one competing interexchange carrier, AT&T, would be subject to them. It is simply untenable that AT&T, alone among its competitors, be burdened by regulatory rules that provide no benefit, impose unnecessary costs, and discourage the achievement of efficiencies that ultimately redound to all consumers of interexchange service." What was "untenable" when applied to AT&T in 1993 suddenly becomes "useful" when applied to the BOCs in 1996. AT&T at 2. AT&T's positions in this docket are impeached by its own prior inconsistent statements, constitute blatant opportunism, and should be given no weight by the Commission.

[6] See, e.g., Notice, para. 6: "an incumbent local exchange carrier may have an incentive to misallocate to its regulated core business costs that would be properly allocated to its competitive ventures."

[7] MCI relies upon audit reports and consent decrees to assert that the BOCs have the incentive to shift costs even under price cap regulation. MCI at 9. The consent decrees cited by MCI do not provide any support for the conclusions that MCI seeks to draw from them. The consent decrees resolved disputes between the affected companies and the Commission without adjudicating the accuracy of the rules interpretations advanced by the staff auditors, and without any finding of wrongdoing on the part of the carriers. They provide no support for changes in the rules.

> change or manipulation of internal transfer prices The pricing of internal transfers above or below market prices therefore produces no benefits to the firm or disadvantage to any consumer or competitor See, e.g., 4 Phillip Areeda and Donald Turner, Antitrust Law, para. 1003a at 218 (1980) (the "postulated advantage of [cost shifting] is a phantom and the postulation a fantasy"); 3 Areeda and Turner, Antitrust Law para. 724b at 196-97 (1978); id., para 725b at 199. See also, Robert Bork, The Antitrust Paradox, p. 228 (1978).[8]

The only exception to this rule may occur under rate of return regulation. By contrast, price cap regulation was expressly designed to eliminate any incentive to manipulate costs.[9] The BOCs and other large LECs have not been subject to rate of return regulation for more than six years. As the Commission recently noted:

> "As the pricing flexibility afforded by the price cap plan increasingly allows LECs to adjust rates to track economic costs, and to respond to competitive challenges, the link between current prices and the initial price cap rates should become more tenuous."[10]

Despite this change in the nature of the regulation applied to the large LECs, MCI continues to argue that the price cap LECs have the incentive and ability to shift costs in a way that will damage customers and competitors.[11] The existence of such cost shifting is the essential premise underlying the arguments for more regulation advocated by MCI and the other IXCs. The premise is false. BellSouth is subject to price cap regulation in the interstate jurisdiction and in each of the nine intrastate jurisdictions where it offers local exchange and exchange access services. Those plans prevent BellSouth from recovering "costs incurred in the provision of

---

[8] Affiliate Transaction Notice, Comments of AT&T at 9, fn. 20.

[9] Comptel argues that the cost methodology prescribed by the Commission for interconnection and unbundled network elements -- TELRIC -- reintroduces the incentives to cross-subsidize that were present under rate of return regulation. Comptel at 7. Comptel ignores the fact that the Commission's rules prohibit the states from considering historical costs in applying the TELRIC methodology, thereby rendering futile any attempt at cross-subsidy through cost-shifting.

[10] Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, FCC 95-132, released April 7, 1995, at para. 299 ("First Report and Order").

[11] MCI at 5.

competitive services from their captive local exchange and exchange access customers."[12] Even if, due to imperfections in the various price cap plans, the BOCs retained some slight ability to manipulate costs, price cap regulation removes the incentive to do so.[13] Unlike the situation under cost-of-service regulation, BOCs can now improve their bottom line by cutting costs and improving productivity. They have no incentive to forego their own profitability in order to advantage an affiliate, or to manipulate artificially the profitability of their regulated and nonregulated lines of business through cost shifting. In the absence of any such incentive, heavy-handed regulations designed to prevent such cost shifting are unnecessary, and contrary to the public interest. As Sprint notes:

> Under a 'pure' price cap regime, LECs would have little incentive to have their regulated services subsidize their nonregulated operations. Higher costs for regulated services would not result in higher prices; rather, the profitability of the regulated services would be reduced. Thus, in theory, carriers would not engage in anticompetitive cross-subsidization activities, and there would be no need for safeguards.[14]

If the Commission is concerned that its existing LEC price cap plan retains sufficient vestiges of rate of return regulation to provide perverse incentives to engage in cost shifting, the

---

[12] Id.

[13] Cost padding and cross-subsidization do not justify higher prices under price cap regulation, but instead decreases the profitability of the carrier. Therefore, there is no incentive for a carrier to engage in such activity. See AT&T Price Cap Order, 4 FCC Rcd 2873, 2893 (1989), para. 36; LEC Price Cap Order, 5 FCC Rcd 6786, 6790-91 (1990).

[14] Sprint at 16-17. Sprint then goes on to assert that the Commission has not, and cannot lawfully, adopt a "pure" price cap plan for the LECs. Clearly, the Commission has not yet adopted such a plan. But it can and should do so. Nothing in Section 201 requires the Commission to utilize cost of service regulation, or any remnant thereof, to regulate the interstate services of the LECs. The Commission adopted a "pure" price cap plan for AT&T, and applied no price regulation at all to Sprint and MCI, all of which are subject to the requirements of Section 201. Furthermore, Section 10 of the 1996 Act requires that the Commission forbear from applying Section 201 to the LECs as soon as the Commission determines that the public interest so requires. Thus, there are no legal impediments to adopting a "pure" price cap plan for the LECs, and eliminating the existing cost-allocation and affiliate transaction rules.

answer is not to impose additional burdensome cost allocation and affiliate transaction rules, but rather to improve the price cap plan by eliminating "sharing". The Commission has tentatively concluded that it should do so in CC Docket No. 94-1, and BellSouth urges the Commission to do just that.[15]

The General Services Administration ("GSA") argues that the Commission cannot eliminate cost allocation rules for telephone companies because such rules are required by Section 220(a)(2) of the Communications Act:

> This mandate takes precedence over the particular set of rules the Commission chooses for the regulation of interstate tariffs, and should not be influenced by them. Indeed more than three-quarters of all LEC costs are subject to state jurisdiction and are entirely unaffected by the Commission's <u>interstate</u> price cap system, whether "pure" or not.[16]

Section 220(a)(2) must be read in concert with Section 10, which mandates that the Commission "forbear from applying any regulation or provision of this Act to a telecommunications carrier or telecommunications service" if the Commission determines that such provision or regulation is not necessary to ensure that rates "are just and reasonable and are not unjustly or unreasonably discriminatory." The Commission has previously determined that price cap regulation is more effective than cost of service regulation, with its reliance on cost allocations to set prices, in protecting the public against cross-subsidy, and has adopted other rules to prevent unreasonable discrimination. Price cap regulation provides carriers with an unambiguous incentive to establish prices that maximize economic efficiency, and preclude carriers from passing on to customers of regulated services costs that result from attempts to

---

[15] <u>See</u>, Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, <u>First Report and Order</u>, FCC 95-132 released April 7, 1995, para. 184.
[16] GSA at 7.

"cross-subsidize" other services or affiliates. Therefore, price cap rates satisfy the "just and reasonable" standard of both Section 10 and Section 201(b) of the Communications Act.

The fact that three-fourths of LEC costs are recovered in the intrastate jurisdiction does not compel a different result. First, the Commission's Part 32 rules are not binding on the states, which are free to adopt their own cost allocation and affiliate transaction rules. See Louisiana Public Service Commission v. FCC, 476 U.S. 355 (1986).[17] Second, many states (including all nine states in which BellSouth provides local exchange and exchange access services) have adopted price caps as the intrastate regulatory model. In such states, the need for cost allocation rules is greatly diminished, if not eliminated altogether.

## III. The Commission Should Not Eliminate Prevailing Company Price as a Valuation Method

Commenters advocating that the Commission eliminate prevailing company price offer no rationale beyond that raised in the Notice.[18] Typical is the "analysis" by TRA:

> [I]t is axiomatic that a company transacting business with an affiliate will benefit from lower or non-existent marketing costs since the company is already known to the affiliate and need not expend funds to capture the affiliate's attention, acquaint the affiliate with the company's operations or otherwise 'win over' the affiliate.[19]

Presumably, TRA describes something as "axiomatic" when it has no evidence to support its position. Both in response to the Affiliate Transaction Notice and in this proceeding, Sprint has provided sworn testimony that rebuts this assumption.

> [T]he notion that an entity which operates in a highly competitive open market (such as Sprint's equipment supplier, North Supply) does not need to devote the

[17] See, e.g., First Report and Order, para. 302: ("Our treatment of accounting costs for interstate ratemaking purposes should have no effect whatever on state treatment of those costs.")
[18] Telecommunications Resellers Association ("TRA") at 12; LDDS WorldCom at 26; MCI at 24; Public Service Commission of Wisconsin at 6-7.
[19] TRA at 12.

same amount of effort and resources to win business from its affiliates is incorrect. In a competitive market with a variety of suppliers offering a plethora of price and service options, an entity has to work just as hard to sell to its affiliates as it does to non-affiliates. Otherwise, its affiliates will look to other suppliers.[20]

Sprint strongly recommends that the Commission continue to allow the use of the prevailing market price method of valuation in affiliate transactions.[21] AT&T also supports the continued use of prevailing company price:

> Whether or not carriers would spend differing amounts on such costs [marketing efforts and transactional costs] for affiliates and non-affiliates, the statute squarely forecloses any rule that would permit any adjustment to the "prevailing price" to reflect such differences. Section 272(b)(5) requires that affiliate transactions be conducted "on an arm's length basis" -- i.e., as if the two entities were in fact non-affiliated. Any other rule would give a BOC undue incentives to grant discounts to its affiliate based on alleged lower marketing costs, thereby lowering the affiliate's costs and facilitating cross-subsidization. Just as the BOC must charge its affiliates tariffed rates where applicable -- which would reflect any marketing costs incurred by the carrier -- so too must the BOC charge the true prevailing market price where there is no tariff.[22]

In this proceeding AT&T argues that the use of prevailing company price should be "available only if the affiliate sells a substantial percentage, by quantity, of that product line to nonaffiliated customers." However, in response to the Affiliate Transaction Notice AT&T stated that requiring a high percentage of sales be to non-affiliates is "entirely over-restrictive" and would "substantially increase AT&T's accounting costs."[23] AT&T also noted that such a requirement "would establish a bias against efficient self-supply, with consequent 'higher costs, lower productivity and a loss of competitiveness.'"[24] AT&T stated then:

---

[20] Sprint at 12, Appendix B, Attachment 1 (Affidavit of Steve L. McMahon).
[21] Sprint at 13.
[22] AT&T at 14-15.
[23] Affiliate Transaction Notice, AT&T Comments at 18. BellSouth disagrees with AT&T's conclusion that charging an affiliate a lower price if that price reflects lower costs would constitute "cross examination".
[24] Id., at 19.

> A market price is established if any significant group of market participants engages in arm's length transactions at that price. In particular, suppose that a significant group of customers buys a good or service at a certain price from an unregulated affiliate of AT&T. These transactions provide evidence that AT&T's regulated operations would have to pay at least that same price if they relied on external supply. Indeed, the next best source of supply, other than AT&T, may be at a higher price."[25]

Again, AT&T has changed its position without explanation simply because the Commission now proposes to apply the affiliate transaction rules to the BOCs, but not AT&T. AT&T's cynical opportunism demonstrates its open willingness to abandon principled positions taken in the past in an attempt to impede competition from the BOCs. The Commission should afford no credibility whatsoever to AT&T's comments in this proceeding.

MCI supports elimination of prevailing company price because of "the difficulties inherent in determining whether a substantial portion of an affiliate's production is being provided to a third party."[26] However, any problems associated with determining whether a prevailing company price truly reflects "arm's length" transactions pales by comparison with the alternatives. MCI itself highlights the problems associated with using fully distributed cost as a valuation method. MCI also points out the problems associated with estimating fair market value, particularly for services transactions.[27] MCI's solution, typically, is vast new layers of regulation that would apply only to the BOCs and their affiliates. BellSouth's solution is much simpler -- simply use common sense in applying the "prevailing company price" method and allow the use of that method whenever the BOC or its affiliate has a sufficient number of third-party transactions to make a prima facie

[25] Id., at 18.
[26] MCI at 24.
[27] MCI at 24-26.

showing that the price reflects an "arm's length" transaction.[28] This approach is not only far simpler than any of the alternatives, but it best meets the requirements of Section 272 of the 1996 Act. There is no legitimate reason for the Commission to eliminate "prevailing company price" as a valuation method.

## IV. The Commission Should Not Require LECs to Estimate Fair Market Value on Services Transactions

In its Comments, BellSouth demonstrated the extreme burden that would be created if the Commission applied the asymmetrical "asset transfer rules" to transactions involving services.[29] This is the most onerous, least beneficial change in the affiliate transaction rules proposed in the Notice. Adoption of this rule would require the LECs and their affiliates to incur hundreds of millions of dollars in costs that have absolutely no value to the firm beyond regulatory compliance.[30] The record compiled in the comment round of this proceeding reinforces that these costs would be wasted.

Sprint points out the difficulty inherent in estimating fair market value for services transactions:

> As Sprint emphasized in its Comments in Docket 93-251 (at 17-21), any attempt to establish fair market value for services is inherently subjective and easily manipulated. Indeed, the Commission previously has found that use of a fair market value test for transactions involving services 'is fraught with the potential for abuse, and would be difficult to monitor.' *Separation of Costs of Regulated*

[28] BellSouth at 29.
[29] BellSouth at 25-29; Appendix A.
[30] BellSouth presented a thoroughly documented analysis by TB&A that shows that if BellSouth were required to perform estimated fair market value studies for non-tariffed services provided to and by only three of its affiliates, it would incur increased administrative costs of over $14.4 million annually. USTA estimated a comparable figure for the LEC industry as a whole of $91 million. That does not include the new affiliate transactions that will result from the separated subsidiary requirements of the 1996 Act. As BellSouth demonstrated in its comments, every dollar expended in performing and defending such studies represents a dollar of lost productivity by the LECs and a dollar of wasted consumer welfare for its customers.

*Telephone Service from Costs of Nonregulated Activities, Order on Reconsideration,* 2 FCC Rcd 6283, 6297, para. 131 (1987). Nothing in the NPRM here suggests that such finding is no longer applicable. On the contrary, the Commission recognizes making 'good faith determinations of the fair market value' for services (and possibly some assets) would be difficult.[31]

Those parties advocating the requirement to estimate the fair market value of services transactions also recognize the essentially subjective nature of such estimates. Their answer: even more rigid new rules.[32] AT&T again shows its lack of credibility by endorsing the Commission's proposal in this docket. When AT&T was faced with compliance with these rules, it stated:

> [T]he incremental cost to AT&T of converting its internal accounting systems to comply with certain aspects of the Commission's proposed new affiliate transactions rules would be substantial. The costs of such revision would of course be in addition to the costs that AT&T already (and alone among its interexchange competitors) bears in complying with the Commission's existing affiliate transaction rules. Therefore, even if the Commission wishes to maintain some regulatory review of AT&T's affiliate transactions, AT&T should not be required to implement the proposed new rules.[33]

Neither should the LECs.

[31] Sprint at 13.
[32] See, e.g., TRA at 13-16; AT&T at 13-14; MCI at 21-22; LDDS WorldCom at 27 ("Allowing the RBOCs to set their own versions of fair market value, based solely on their own methods, will lead to inconsistent and confusing results that will only give the RBOCs significant cover and leeway to shift costs and discriminate.")
[33] Affiliate Transaction Notice, Comments of AT&T at 19.

## V. The Commission Cannot Extend its Jurisdiction to Intrastate Matters

Several of the commenters who favor imposing burdensome new requirements on the LECs argue that the Commission should assume jurisdiction over intrastate services based on strained interpretations of the 1996 Act. For example, MCI states:

> In the Notice, the Commission tentatively concludes that the category of "telemessaging services," as defined in Section 260(c), falls within the overall category of information services, and is thus governed by the separate affiliate and other requirements of Section 272. MCI agrees with this tentative conclusion.[34]

MCI misreads the Notice. Nowhere in the Notice does the Commission suggest that BOCs' existing, intraLATA information services are subject to the separate subsidiary requirement that Section 272 imposes on the provision of interLATA telemessaging services. Under the MFJ, the BOCs have been constrained from providing interLATA services, including interLATA information services. MCI does not contend that any of the BOCs' existing information services, including telemessaging services, violated the MFJ. Therefore, Section 272 has no application to the BOCs existing telemessaging services. MCI's request that the Commission require BOCs to "remove all embedded costs related to telemessaging, including any common or shared costs, from their Part 32 accounts" is entirely unjustified, and must be denied.[35] As the Notice correctly recognizes:

> "Our present Part 64 rules classify telemessaging service as a nonregulated activity for Title II accounting purposes. Consequently, provision of telemessaging services is already governed by our Part 64 rules . . . ."[36]

[34] MCI at 11.
[35] MCI at 12.
[36] Notice, para. 30.

Nothing in the Notice or the 1996 Act justifies any new requirements for BOC provision of intraLATA telemessaging services.[37] MCI's misguided interpretation of the 1996 Act must be rejected.[38]

Voice Tel's request that the Commission require the BOCs and other LECs to transfer their existing intraLATA telemessaging services into a separate subsidiary is beyond the scope of this proceeding.[39] The logic employed by Voice Tel to reach the conclusion that Section 272 requires such a result can best be described as bizarre. First, the separate subsidiary requirement of Section 272 applies only to interLATA information services.[40] Nothing in Section 272 affects the BOCs' provision of its existing intraLATA telemessaging services.[41] Nor is there any provision in the 1996 Act that conditions BOC entry into interLATA services on its transferring existing intraLATA services, including intraLATA telemessaging services, to a separate subsidiary. Voice Tel is simply reading into the 1996 Act requirements which are not there.[42]

---

[37] Section 311 of the Senate Bill authorized the Commission, under certain circumstances, to require that existing BOC telemessaging services be transferred to a separate affiliate. That proposal was not adopted in conference, and Section 260 as adopted contains no such authorization. See Joint Explanatory Statement of the Committee of Conference, CR-137-138.

[38] Compare Sprint at 16: "The portion of the new investment associated with telemessaging should be allocated initially to nonregulated services, and therefore should not be treated as exogenous. The remainder of the new investment should be treated as exogenous only where it is the result of 'administrative, legislative or judicial action ... beyond the control of the carriers' and not otherwise reflected in the price cap formula. Any investment which is not the result of such action should be considered a general network upgrade and should not be treated as exogenous."

[39] Voice Tel at 13.

[40] Section 272(a)(1)(C) of the 1996 Act is specific in referring to "interLATA information services."

[41] See NARUC at 4.

[42] Compare PRTC at 3: "It would be contrary to Congress' intent to create a 'pro-competitive, de-regulatory national [telecommunications] policy framework' if the Commission were to impose a separate affiliate requirement for telemessaging services where Congress declined to do so."

Voice Tel complains about competitive advantages available to telephone companies that provide telemessaging services on an integrated basis. Those "advantages" are, in fact, operational efficiencies that the Commission's rules were designed to make available to customers. Voice Tel's services have advantages of their own that are not available to telephone company customers. For example, Voice Tel is able to offer service over a network that serves over 3500 cities and communities throughout the United States, Canada and Puerto Rico.[43] The BOCs are currently limited to providing service within a LATA.[44] Another advantage enjoyed by Voice Tel is lower overheads due to the absence of cost allocation requirements imposed by regulators. Both the telephone companies and their non-regulated competitors such as Voice Tel have competitive advantages that shape the nature, scope and price of their service offerings. Together, they offer customers a wider array of options than would be available if the Commission were to attempt to manage the competitive outcome by further handicapping the telephone companies. Such rules might help competitors, but only by harming competition. What Voice Tel is requesting is simply that the Commission deprive telephone company customers of the efficiencies that derive from integrated operations.[45]

---

[43] Voice Tel at 2. In light of the extensive operations claimed by Voice Tel in its comments, the claim that the telephone companies' ability to offer voice messaging services on an integrated basis "constitutes an almost insurmountable barrier" rings hollow. Voice Tel at 3.

[44] Any telephone company that offers voice messaging services on an integrated basis necessarily limits the geographical scope of its offerings. This is another of the competitive tradeoffs that shape the business strategy of competitors. The Commission should not impose rules designed to prevent competitors from offering services that capitalize on their inherent advantages.

[45] See, e.g., Voice Tel at 6: "Although accounting rules can be devised to segregate the cost of these types of activities, the synergistic effect cannot be costed." Those synergies are precisely the benefits of integrated operations that BOC customers are entitled to receive in a competitive market.

The claim by AT&T that §§ 271-272 give the FCC express jurisdiction over intrastate, interLATA services is without merit and must be rejected.[46] As NARUC notes:

> Both Section 271 and 272 are silent on the jurisdictional division of responsibilities. In the absence of a direct directive to establish rules applicable to intrastate interLATA service, both § 152(b) and § 601(c)(1), by their own terms, assume that States retain jurisdiction over intrastate matters.[47]

Citing Louisiana PSC v. FCC, 476 U.S. 535 (1986), The New York Department of Public Service states:

> [A]bsent an express directive to establish rules applicable to intrastate interLATA services, the Commission lacks the authority to do so.[48]

The Public Service Commission of Wisconsin ("PSCW")[49] and the Missouri Public Service Commission ("MoPSC")[50] both deny that §§ 271-272 confer any jurisdiction on the Commission to promulgate rules regarding intrastate services. State commissions have regulated the intrastate, interLATA market since divestiture, and nothing in the 1996 Act purports to transfer that jurisdiction to the Commission.

## VI. The Commission Must Reject Attempts by IXCs and Others to Expand the Scope of this Proceeding

The non-LEC parties to this proceeding attempt to inject a whole range of issues that exceed the scope of the Notice. These attempts must be rejected. The Notice defines the scope of this proceeding, and commenting parties cannot expand the proceeding by requesting that the Commission adopt regulations that are not fairly alerted by the Notice. Thus, the Commission

[46] AT&T at 6.
[47] NARUC at 4.
[48] NYDPS at 5.
[49] PSCW at 3-4.
[50] MoPSC at 1.

should reject the attempt of AT&T and others to regulate the prices charged by the separated affiliates of the BOCs.[51] The <u>prices</u> charged, as opposed to the amount <u>booked</u>, as a result of affiliate transactions, is not at issue.[52] The status of BOC separated subsidiaries as "dominant" or "non-dominant" is beyond the scope of this proceeding.[53] LEC access charge prices are not at issue here, despite MCI's attempt to inject that issue into this proceeding.[54] Nor is the form of regulation that should be applied to the separated affiliates of the BOCs.[55] MCI makes a strained attempt to read into Section 272(e)(3) a requirement that the Commission impose price regulation on the separated affiliate. The 1996 Act does not require the Commission to regulate the prices charged by the separated affiliates. As the Commission recently reaffirmed in the <u>BOC Out of Region Order</u>:

> These rules are designed to prevent local exchange carriers from imposing the costs and risks of their competitive ventures on local telephone ratepayers. These rules do not require carriers or their affiliates to charge any particular prices for assets transferred or services provided; rather, they require carriers to use certain

---

[51] AT&T at 11 (requesting that the Commission require the BOCs' interLATA affiliates to reflect access charges in its end-user rates); LDDS WorldCom at 15-16 (same).

[52] LDDS WorldCom, at 28, asks the Commission to adopt a rule that would provide: "[w]here more than one entity is involved and more than one price [is] being charged, the affiliate must be compelled to pay the <u>highest</u> price that any other entity willingly pays the operating company." In addition to being beyond the scope of this proceeding, the position advanced by LDDS WorldCom is clearly prohibited by the non-discrimination provisions of the 1996 Act. In the <u>Interconnection Order</u>, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, <u>First Report and Order</u>, FCC 96-325, released August 8, 1996, at para. 860, the Commission defines "discrimination" as charging similarly situated customers different prices, or charging dissimilar customers the same price. WorldCom's proposal to require the BOC to charge its affiliate the highest rate paid by any third party, regardless of similarity, is a requirement to engage in unlawful discrimination.

[53] AT&T at 9.

[54] MCI at 27-28.

[55] <u>Id.</u>

specified valuation methods in determining the amounts to record in their Part 32 accounts, regardless of the prices charged.[56]

The American Public Communications Council ("APCC") attempts to inject the issue of whether BOC payphone operations should pay a "royalty" to the BOCs for intangible benefits like the BOC name, reputation and logo.[57] Besides being beyond the scope of this proceeding, APCC's request is without merit. BellSouth is a member of the RBOC Payphone Coalition, which is filing separate reply comments addressing the issues arising out of Section 276 of the 1996 Act. BellSouth supports those comments and will not duplicate those arguments here.

## VII. Miscellaneous Issues

MCI asserts that the Commission should create subsidiary accounts for interLATA services, following the model established with respect to video dialtone.[58] The Commission should reject MCI's proposal. Congress expressly repudiated the Commission's video dialtone rules in Section 302(b)(3) of the 1996 Act. As the Conference Report indicates, Congress found that the video dialtone rules were too "rigid" and "created substantial obstacles to the actual operation of open video systems."[59] The Conference Report states:

> New section 653(c) sets forth the reduced regulatory burdens imposed on open video systems. There are several reasons for streamlining the regulatory obligations of such systems. First, the conferees hope that this approach will encourage common carriers to deploy open video systems and introduce vigorous competition in entertainment and information markets. Second, the conferees recognize that common carriers that deploy open systems will be "new" entrants in established markets and deserve lighter regulatory burdens to level the playing

[56] Bell Operating Company Provision of Out-of-Region Interstate, Interexchange Services, CC Docket No. 96-21, Report and Order, FCC 96-288, released July 1, 1996 ("BOC Out of Region Order").
[57] APCC at 18-21.
[58] MCI at 14.
[59] See Joint Explanatory Statement of the Committee of Conference, CR-179.

> field. Third, the development of competition and the operation of market forces mean that government oversight and regulation can and should be reduced.[60]

The same reasons that caused Congress to repudiate the video dialtone rules should cause the Commission to refuse to impose similar requirements on BOCs' provision of interLATA services. The Commission can smother the BOCs potential entry into interLATA services in a blanket of regulations, as MCI and the other IXCs advocate. Or the Commission can encourage entry, level the playing field, and promote competition by relying on market forces to replace regulation, as Congress clearly intended.

MCI also seeks to create vast new regulations to implement the self-explanatory requirement of Sections 272(b)(5) that transactions between a BOC and the separated affiliate be "reduced to writing and available for public inspection."[61] The Conference Report thought that this language was sufficiently clear that no explanation was offered.[62] Yet MCI would expand this simple provision to require the BOCs to file quarterly reports of affiliate transactions, including "providing a description of the asset or service transferred, the transfer price, and the method of valuation."[63]

> The transaction list should be provided to the Commission and should also be made available to the public through other means, such as the Internet, as proposed in the Notice. Interested parties could then request copies of any particular contract, agreement, or other arrangement from the BOC. The requirement that transaction information be made available for public inspection would have little value if summary information in a clear and consistent format were not readily available to the public. The summary of transaction information should also function as a statement of facilities, services, or information that other providers of interLATA services may obtain from the BOCs on the same terms and conditions, pursuant to Section 272(e)(2).[64]

---

[60] See Joint Explanatory Statement of the Committee of Conference, CR-178.
[61] MCI at 29.
[62] See Joint Explanatory Statement of the Committee of Conference, CR-152.
[63] MCI at 30.
[64] MCI at 30.

MCI would take a simple, straightforward requirement that contracts be in writing and available for public inspection, into a requirement that the BOCs create a menu of services from which competitors may shop. Nothing in the Act requires the BOCs to create summaries of their affiliate contracts, file them with the Commission, post them on the Internet, or make most such services available to third parties. Section 272(e)(2) does not require BOCs to make all services provided to affiliates available to third parties, only those "facilities, services, or information concerning <u>its provision of exchange access to the affiliate</u>." If a BOC provides legal, tax planning or other administrative services to its separated affiliate, it is not required to provide such services to MCI! MCI takes separate provisions of the 1996 Act and attempts to combine them in ways that are grossly anticompetitive and unreasonably burdensome on the BOCs and their affiliates. Its proposals must be rejected.

State regulators ask the Commission to adopt detailed requirements for the independent audits required by Section 272.[65] The Commission should not codify the NARUC resolutions into the federal rules. The NARUC resolutions contain provisions, such as those dealing with the selection of the auditor, that were expressly dropped from earlier bills in the final version of the 1996 Act. Provisions in the resolution, such as the requirement that the independent auditor be selected through a Request for Proposal process, could have unintended consequences and is inconsistent with the way independent auditors are generally retained. Furthermore, the NARUC resolution provides for a much more active role for state auditors than is required by the statute. Section 272 does not provide for a federal/state joint audit, which is what the NARUC resolution

[65] NARUC at 5-6; NYDPS at 10; MoPSC at 1; Florida Public Service Commission at 3-4; PSCW at 13.